DEPARTMENT OF STATE REVENUE

04-20100733.LOF

Letter of Findings: 04-20100733
Gross Retail Tax
For the Years 2007, 2008, and 2009

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ISSUES

I. Direct Production – Gross Retail Tax.

Authority: IC § 6-2.5-2-1(a); IC § 6-2.5-2-1(b); IC § 6-2.5-3-1(a); IC § 6-2.5-3-2(a); IC § 6-2.5-5-3(b); IC § 6-2.5-5-4; IC § 6-2.5-5-3; IC § 6-8.1-5-1(c); Indiana Dep't of Revenue v. Cave Stone Inc., 457 N.E.2d 520 (Ind. 1983); Indiana Dept. of State Rev. v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); North Central Industries, Inc. v. Indiana Dep't of State Revenue, 790 N.E.2d 198 (Ind. Tax Ct. 2003); Rhoade v. Ind. Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282, 283 (Ind. Tax Ct. 1999); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629 (Ind. Tax Ct. 1999); General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); 45 IAC 2.2-5-8(a); 45 IAC 2.2-5-8(c); 45 IAC 2.2-5-8(c)(1); 45 IAC 2.2-5-8(d); 45 IAC 2.2-5-8(k); 45 IAC 2.2-5-10(i)(2).

Taxpayer argues that the Department of Revenue erred when it determined that certain items of equipment were not directly involved in the direct production of Taxpayer's products.

II. Labels – Gross Retail Tax.

Authority: IC § 6-2.5-5-3(b); IC § 6-2.5-5-6; IC § 6-2.5-5-8(b); 45 IAC 2.2-4-14; 45 IAC 2.2-5-10(i)(2); 45 IAC 2.2-5-15; 45 IAC 2.2-5-16(a); 45 IAC 2.2-5-16(d)(1); American Heritage Dictionary of the English Language (1969).

Taxpayer maintains that labels and labeling equipment it purchased are exempt from sales/use tax.

III. Duplicate Entries.

Authority: IC § 6-8.1-5-1(c).

Taxpayer states that the Department of Revenue's audit report contains instances in which the identical item was counted twice for purposes of determining Taxpayer's sales/use tax liability.

IV. Research and Development – Gross Retail Tax.

Authority: IC § 6-2.5-5-40; IC § 6-2.5-5-40(b)(1)(A); IC § 6-2.5-6-16; IC § 6-8.1-5-1(c); Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282 (Ind. Tax Ct. 1999); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629 (Ind. Tax Ct. 1999); Indiana Dept. of State Rev. v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); Sales Tax Information Bulletin 75 (October 2008).

Taxpayer argues that prototypes it purchased are exempt from sales/use tax.

V. Electrical Conduit – Gross Retail Tax.

Authority: 45 IAC 2.2-5-8(c)(2)(B).

Taxpayer maintains that its purchase of electrical conduit is exempt from sales/use tax.

VI. Conveyor Replacement Parts – Gross Retail Tax.

Authority: IC § 6-2.5-5-3(b); 45 IAC 2.2-5-8(f)(3); 45 IAC 2.2-5-10(i)(2).

Taxpayer states that it is entitled to a partial exemption on the purchase of parts used in Taxpayer's conveyor systems on the ground that the conveyors are used to transport work-in-process.

VII. Ten-Percent Negligence Penalty.

Authority: IC § 6-8.1-5-1(c); IC § 6-8.1-10-2.1(a)(3); IC § 6-8.1-10-2.1(a)(2); IC § 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer argues that the Department of Revenue should exercise its discretion to abate the ten-percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is an Indiana business that provides "packaging solutions." Taxpayer designs the packaging, manufactures the packaging, packages its customer's products, and delivers the final product to its customers. Taxpayer manufactures clamshells, blister packages, point-of-purchase packages, paperboard packages, blister cartons, and packaging inserts. Taxpayer also provides its customers logistical, inventory, and "supply chain solutions."

The Department of Revenue (Department) conducted an audit review of Taxpayer's business and tax records. The audit resulted in the assessment of additional sales/use tax. Taxpayer disagreed with a portion of the assessment. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for its protest. This Letter of Findings results.

I. Direct Production – Gross Retail Tax.

DISCUSSION

Taxpayer maintains that its purchase of certain equipment was exempt because the equipment is used to manufacture its packaging and its packaged products. Specifically, Taxpayer argues that the following items are exempt from sales tax: autoloader, de-trayer, depalletizer, and Motoman robots.

A. Equipment.

During the course of the audit review, the Department's representative toured Taxpayer's facility. The audit report noted as follows. "[I]t was determined that the taxpayer has a number of pieces of equipment that help[] to facilitate movement of raw materials to the first stage of manufacturing." These items include autoloaders, detrayers, depalletizers, as well as Motoman robots. The audit determined that the use of these items was considered to be taxable since these items are responsible for the movement of raw materials before they enter the first step in production.

Taxpayer disagrees stating that these items of equipment – along with associated replacement parts – are used in the Taxpayer's integrated production process and are exempt from sales/use tax.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing sales/use tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the Department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." Indiana Dept. of State Rev. v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988).

The exemption to which Taxpayer aspires, IC § 6-2.5-5-4, like all tax exemption provisions, is strictly construed against exemption from the tax. Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282, 283 (Ind. Tax Ct. 1999); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629, 636 (Ind. Tax Ct. 1999).

Therefore, in order for Taxpayer to prevail on the different issues it raises, Taxpayer must demonstrate that the initial assessment was "wrong" and that it is instead entitled to a sales tax exemption which is "strictly construed" in favor of taxation.

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b).

Indiana also imposes a complementary excise tax called "the use tax" on "the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC § 6-2.5-3-2(a). Use means the "exercise of any right or power of ownership over tangible personal property." IC § 6-2.5-3-1(a).

In effect and practice, the use tax is functionally equivalent to the sales tax. See Rhoade v. Ind. Dep't of State Revenue, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

However, the general rule is that all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly or finishing of tangible personal property are taxable. 45 IAC 2.2-5-8(a). The exemption only applies to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. Id. Machinery, tools, and equipment are directly used in the production process if they have an immediate effect on the article being produced. 45 IAC 2.2-5-8(c). A machine, tool, or equipment has an immediate effect on the product being produced if it is an essential and integral part of an integrated process that produces the product. 45 IAC 2.2-5-8(c); Indiana Dep't of Revenue v. Cave Stone Inc., 457 N.E.2d 520 (Ind. 1983). An integrated process is one where the total production process is comprised of activities or steps that are functionally interrelated and where there is a flow of "work-in-process." 45 IAC 2.2-5-8(c)(1).

IC § 6-2.5-5-4 extends the exemption to tools used to build exempt machinery and equipment.

> Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for his direct use in the direct production of the machinery, tools, or equipment described in section 2 or 3 of this chapter.

To summarize, machinery, tools, and equipment purchased for direct use in the production of manufactured goods are subject to use tax unless the property used has an immediate effect on the goods produced and is essential to the integrated process used to produce the marketable goods.

Proper application of the exemption requires determining at what point does "manufacturing" begin and at what point does "manufacturing" end? 45 IAC 2.2-5-8(d) states:

> Pre-production and post-production activities. "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.

This question is especially pertinent in Taxpayer's circumstances because Taxpayer is not a traditional "manufacturer" in the ordinary sense of the word. Taxpayer does not manufacture automobiles, widgets, or batteries. Bearing that in mind, the audit found that the autoloader, de-trayer, depalletizer, and motorman robots were not exempt from sales/use tax because the equipment was used outside Taxpayer's production process. As stated in the audit report, "these items are responsible for the movement of raw materials before they enter the

first step in production."

Taxpayer defines itself as offering packaging "solutions." For purposes of this Letter of Findings, the "solution" at issue involves the packaging of batteries. As part of that "solution," Taxpayer takes possession of electric batteries and incorporates those batteries into the packaging which Taxpayer has developed and manufactured. Taxpayer states that Taxpayer "does not own the batteries which become a part of the finished product." However, Taxpayer states that the fact that it does not own the batteries, "it is not determinative of the beginning or ending of the integrated process and what equipment within [the process] constitutes [Taxpayer's] integrated process."

Taxpayer describes its packaging of batteries as follows:

> The battery packaging line begins at the point when [Taxpayer] forms the plastic trays that will eventually hold the batteries.
>
> In a separate building [Taxpayer] owns and operates thermo-former equipment that creates the plastic trays/blister packs specifically designed to hold sizes and shapes of batteries and other goods.
>
> These plastic trays are boxed and move as work in process to [Taxpayer's] second facility where they are placed on a conveyor.
>
> The next step in the process is a paperboard/cardboard components of the package is placed on the conveyor in relationship to the plastic trays.
>
> The components are moved down the conveyor where the detrayers remove the batteries from the orange containers and the robots add the correct number of batteries to the specific plastic tray via sucker tubes.
>
> This work-in-process is further moved down the line where glue is applied and the package is folded and molded into a single unit.
>
> This unit is further processed by the addition of typed codes and the application of required labels including UPC codes, and other customer required labels (not shipping labels).
>
> In the final step in this process, the units are packaged into a required corrugated carton.

Taxpayer maintains that the autoloaders, detrayers, depalletizers, Motoman robots are exempt because these items of equipment are "essential and integral to the continuous integrated manufacturing/assembling process by measuring and applying the correct number of batteries to the assembled product being sold to the customer."

Under IC § 6-2.5-5-3(b):

> Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

In addition, 45 IAC 2.2-5-8(c) states:

> The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

Finally, 45 IAC 2.2-5-8(k) states:

> "Direct production, manufacture, fabrication, assembly, or finishing of tangible personal property" is performance of a series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. The change in form, composition, or character must be a substantial change, and it must result in a transformation of property into a different product having a distinctive name, character, and use. Operations such as compounding, fabricating, or assembling are illustrative of the types of operations which may qualify under this definition.

This test requires two steps: direct use and direct production of other tangible personal property. At this point, a series of questions must be addressed. What is the role of the equipment? Is this role an integral part of the process of producing tangible personal property? What is the "tangible personal property" being produced? Is the tangible personal property changed as a result of the equipment?

The audit report explains that the batteries are brought to the packaging line in the orange trays which hold a "few hundred" batteries. From the orange trays, the batteries are loaded into the "autoloader." From the autoloader, the batteries are transported to a different area of the plant where a robot picks up the batteries and places them into Taxpayer's blisterpacks. The blisterpacks are moved to receive the backing cards. The detrayers and depalletizers are "used throughout" this process. The audit report indicates that the "depalletizer" is a "machine that removes the... batteries... to a conveyor that will then transport those same batteries to the first point in production." The audit indicated that the depalletizer moved "raw material" and concluded that the depalletizer was considered "a pre-production piece of equipment." The audit came to a similar conclusion regarding the "detrayer" and that it was used to remove "raw materials from a container and introduce[e] them to a conveyor system that will then transport them to the first stage of production."

Similarly, the audit concluded that robots simply move the raw materials – specifically the batteries – and placed those batteries into the blisterpacks.

In considering Taxpayer's protest, it is necessary to understand that Taxpayer performs two functions. Taxpayer designs and manufactures packaging. Taxpayer also provides services to companies. Taxpayer explains that, its "goal is to provide a comprehensive outsourced packaging supply chain solution that will make our customers faster and more flexible while lowering their packaging, supply chain and inventory costs."

The issue is whether the specific items of equipment - autoloaders, detrayers, depalletizers, Motoman robots – are exempt because these items of equipment are "directly used in the production process; i.e., they have an immediate effect on the article being produced." IC § 6-2.5-5-3(b).

The Department must disagree with Taxpayer's contention that the equipment is directly used to manufacture Taxpayer's packaging. These items of equipment are used to provide a service to the battery manufacturers; Taxpayer does not create batteries; Taxpayer creates and manufactures blisterpacks, cardboard backings, "clamshells," cartons, packaging inserts, and specialized "point-of-purchase" packaging. At some point, Taxpayer's facility ceases to be a manufacturer of packaging and becomes a service provider by sorting, classifying, and assembling the third parties' batteries into packaging of various sizes and features. See North Central Industries, Inc. v. Indiana Dep't of State Revenue, 790 N.E.2d 198 (Ind. Tax Ct. 2003). ("Mere packaging does not constitute production where the items being packaged by the taxpayer have not themselves been fashioned into new, marketable goods.") Whether one classifies the items at issue as "pre-production" or as a separate "branch" of Taxpayer's operation, Taxpayer's packaging materials (the blisterpacks, clamshells and so on) are indeed "new marketable goods" but the batteries are not. Taxpayer does not assemble batteries; Taxpayer does not fabricate batteries; Taxpayer does not substantially change the "form, composition, or character" of the batteries. The process by which its customers' batteries are transported and combined with the packaging materials is a service provided by Taxpayer to those customers and equipment associated with providing that service is not entitled to the exemption.

Taxpayer makes a secondary argument stating that the items of equipment are "an essential and integral part of [an] integrated process...." which produces packaged batteries. To that end, Taxpayer cites to General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991), aff'd 599 N.E.2d 588 (Ind. 1992) asking that the Department treat its entire operation as one continuous, uninterrupted, "integral" process in which end result is complete, packaged battery packs.

In General Motors, the automobile manufacturer shipped component automobile parts to its plants and claimed an exemption for the purchase of items employed in the interdivisional transfer of those components parts. The court held that the automobile manufacturer's packing materials were part of the integral process whereby the manufacturer produced its finished product. Therefore, the automobile manufacturer's packing materials were exempt under IC § 6-2.5-5-3. The court reached that decision after finding the automobile manufacturer's widely separated production facilities formed a cohesive, singular production unit in which the claimant's "manufacture of finished marketable automobiles [was] accomplished by one continuous integrated production process within which the transport of parts from component plants to assembly plants [was] an essential and integral part." General Motors, 578 N.E.2d at 404.

In finding that the automobile manufacturer's production process encompassed manufacturing activities performed at multiple sites, the court identified a number of significant facts. Specifically, the court found that "[t]he facts in the case as well as previous judicial findings indicate GM's production process is by nature highly integrated. The court's sole concern, however, is whether GM's manufacture of finished automobiles qualifies as one continuous integrated production process for the purpose of exemption from sales/use tax." Id. at 402. (Internal citations omitted).

Taxpayer believes that it is entitled to the same tax treatment as the automobile manufacturer in General Motors. Taxpayer believes that its manufacturing process only ends when the batteries are packaged; According to Taxpayer, its "process beings in one plant and continues in the second plant all steps being one continuous process." However, in General Motors, the automobile manufacturer created the items which it packed and which were used to build new automobiles. Id. at 402-03. In that case, the Tax Court found that the packing material at issue was an essential and integral part of a production process that resulted in the creation of other tangible personal property – specifically the new automobiles. Id. at 403. In Taxpayer's case, it does not create the batteries that it packages and its reliance on General Motors is misplaced. The Department concludes that Taxpayer performs two distinct functions; Taxpayer designs and manufactures packaging materials and Taxpayer packages its customers' batteries. The first function entitles Taxpayer to claim the manufacturing exemption for equipment directly involved in the direct production of the packaging materials. The second function constitutes a service performed on behalf of its customers which does not entitle it to the exemption.

B. Replacement Parts.

Taxpayer maintains that certain replacement parts associated with the above-referenced, specific items are exempt. Taxpayer apparently relies on the Department's regulation found at 45 IAC 2.2-5-10(i)(2) which states in its entirety:

> Replacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, however, are exempt from tax.

As noted in Part A above, the Department is unable to agree that Taxpayer has met its burden of establishing

that the equipment at issue is directly involved in the direct production of Taxpayer's packaging materials. Necessarily, the replacement parts for that equipment is not exempt pursuant to 45 IAC 2.2-5-10(i)(2).

II. Labels – Gross Retail Tax.

DISCUSSION

Taxpayer purchased labels from two vendors without paying sales tax. Taxpayer claimed that the labels were exempt because "the labels that they had purchased were incorporated into the packages of the items and in essence became part of the product that was being resold." The audit report indicates that "the taxpayer was asked to provide specific tangible examples of the labels that they had purchased to support their claim that the labels... were actually incorporated into the products that they were producing." However, the report indicates that "[T]axpayer merely stated that the labels and stickers were incorporated into the products. However the [T]axpayer did not provide any evidence that would confirm the [T]axpayer's claims."

Taxpayer has provided a substantial listing of the labels which it purchases. Taxpayer includes, "UPC labels," "structured article labels," "Hello Kitty" labels, "Rush to floor" labels, and "Do not stack labels."

In general, Taxpayer uses the labels in three different ways. Taxpayer fastens labels to the retail product which is sold to the ultimate consumer. Taxpayer fastens labels on the "required packaging" stipulated in the contract between Taxpayer and the battery manufacturer. Taxpayer also fastens labels on the cardboard "standees" which are placed in retail locations and which are used to prominently display packaged batteries.

Taxpayer explains that it purchases various labels which its customers require. Taxpayer notes that its customers provide Taxpayer "with a bill of materials for each project [and that] Included in the bill of materials are labels from American Printing and occasionally other vendors to be incorporated in the product or in the required packaging." Taxpayer explains that the labels "are incorporated into the product or required packaging and sold to the customer...." Taxpayer further explains that it "derives no benefit from the.... labels such as 'caution' labels required by the customer...." Taxpayer apparently believes that the exemption is determined by whether the labels are necessary and functional.

A. Purchase for Resale.

Taxpayer argues that Taxpayer purchases the labels for resale to its customers. Taxpayer explains that it receives directions from its customers which specify the manner in which Taxpayer's products are shipped to the customers. Taxpayer explains that the labels are purchased for resale to the customers. As explained, "[Taxpayer] does not participate in the ordering of these labels, but does acquire them in the ordinary course of business to resell them for consideration." Taxpayer further explains that the "labels are delivered to and billed to [Taxpayer] by [printer]" and that "[Taxpayer] applies the labels as directed by the customer and resells them to the customer as part of the consolidated price invoiced to the customer."

In support of its argument, Taxpayer cites to IC § 6-2.5-5-8(b) which states:

> Transactions involving tangible personal property other than a new motor vehicle are exempt from the state gross retail tax if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of the person's business without changing the form of the property.

In addition, Taxpayer cites to 45 IAC 2.2-4-14 which states in part:

> (a) The state gross retail tax shall not apply to sales of any tangible personal property which is to be incorporated by the purchaser as a material or an integral part into tangible personal property produced for sale by such purchaser in the business of manufacturing, assembling, refining or processing.
>
> (b) The exemption provided by this regulation [45 IAC 2.2] applies only to tangible personal property to be incorporated as a material or an integral part into tangible personal property produced for sale by a purchaser engaged in the business of manufacturing, assembling, refining or processing. This regulation [45 IAC 2.2] does not apply to persons engaged in producing tangible personal property for their own use.

As further support for its position, Taxpayer cites to 45 IAC 2.2-5-15 which states in its entirety:

> (a) The state gross retail tax shall not apply to sales of any tangible personal property to a purchaser who purchases the same for the purpose of reselling, renting or leasing, in the regular course of the purchaser's business, such tangible personal property in the form in which it is sold to such purchaser.
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> (b) General rule. Sales of tangible personal property for resale, rental or leasing are exempt from tax if all of the following conditions are satisfied:
>
> (1) The tangible personal property is sold to a purchaser who purchases this property to resell, rent or lease it;
>
> (2) The purchaser is occupationally engaged in reselling, renting or leasing such property in the regular course of his business; and
>
> (3) The property is resold, rented or leased in the same form in which it was purchased.
>
> (c) Application of general rule.
>
> (1) The tangible personal property must be sold to a purchaser who makes the purchase with the intention of reselling, renting or leasing the property. This exemption does not apply to purchasers who intend to consume or use the property or add value to the property through the rendition of services or performance of work with respect to such property.
>
> (2) The purchaser must be occupationally engaged in reselling, renting or leasing such property in the

regular course of his business. Occasional sales and sales by servicemen in the course of rendering services shall be conclusive evidence that the purchaser is not occupationally engaged in reselling the purchased property in the regular course of his business.

(3) The property must be resold, rented or leased in the same form in which it was purchased.

As an example of labels which it purportedly resells to its customers, Taxpayer points to "caution" labels which are affixed to shipping containers which contain lithium batteries. Taxpayer explains that these labels are required by its customers because the lithium batteries cannot "legally be shipped by air."

The Department is unable to agree that it acquired the labels at issue for resale to its customers. The regulation states that the exemption applies to persons who acquire the exempt property for resale "in the ordinary course of the person's business without changing the form of the property." As noted, Taxpayer is in the business of providing "packaging solutions" for its customers. That business consists of two components; Taxpayer manufactures packaging materials such as blisterpacks and Taxpayer provides packaging services in which it incorporates into its customers' products – such as batteries – into the manufactured packaging materials. Other than those labels which are directly affixed to its manufactured packaging, the labels at issue are not incorporated into the product which Taxpayer sells to its customers.

B. Non-returnable Packaging.

Taxpayer makes a secondary argument arguing that the labels constitute "non-returnable packaging materials" exempted under 45 IAC 2.2-5-16(a) which states as follows:

(a) The state gross retail tax shall not apply to sales of nonreturnable wrapping materials and empty containers to be used by the purchaser as enclosures or containers for selling contents to be added, and returnable containers containing contents sold in a sale constituting selling at retail and returnable containers sold empty for refilling.

Although Taxpayer specifically cites to 45 IAC 2.2-5-16(a), another portion of the same regulation is helpful in understanding the issue. 45 IAC 2.2-5-16(d)(1) states:

(1) Nonreturnable wrapping material and empty containers. To qualify for this exemption, nonreturnable wrapping materials and empty containers must be used by the purchaser in the following way:

(A) The purchaser must add contents to the containers purchased; and

(B) The purchaser must sell the contents added.

The Department is similarly unable to agree that it is entitled to the exemption it seeks because there is no evidence that the labels are not "enclosures or containers for selling contents to be added...."

Taxpayer argues that its purchase of labels is exempt because the labels are incorporated into Taxpayer's product. Presumably, taxpayer argues for application of IC § 6-2.5-5-6 which states in part as follows:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for incorporation as a material part of other tangible personal property which the purchaser manufactures, assembles, refines, or processes for sale in his business.

Taxpayer's argument that its customers require the labels and therefore the labels become part of the product is similarly unpersuasive. While Taxpayer's labels may be required by its customers and/or an essential component within Taxpayer's distribution process, the labels do not become "material parts" of Taxpayer's products. The labels do not "constitute a material or integral part of the finished product." The labels are not essential to Taxpayer's finished products and do not affect the performance or utility of those finished products. Thus, the labels do not benefit the ultimate consumer. The labels are merely the ancillary means by which the Taxpayer's finished product finds its way to the ultimate consumer. Therefore, Taxpayer has not shown that the labels qualify for the "incorporation exemption." The labels appear to be no more and no less than what the term commonly means; "[A] means of identification; especially a small piece of paper or cloth attached to an article to designate its origin, owner, contents, use, or destination." American Heritage Dictionary of the English Language 730 (1969). The Department disagrees that "[l]ables ordered by and for customer specification are not a product used by [Taxpayer] but rather a product acquired for resale or purchased as required non-returnable packaging/wrapping."

C. Replacement Parts.

As noted in Part I above, Taxpayer maintains that certain replacement parts associated with the above-referenced, specific items are exempt. Taxpayer apparently relies on the Department's regulation found at 45 IAC 2.2-5-10(i)(2) which states in its entirety:

Replacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, however, are exempt from tax.

Taxpayer also asserts that labeling equipment used to print the labels are exempt pursuant to IC § 6-2.5-5-3(b) because they are directly used in the direct production of the taxpayer's product. However, since the labels have been determined to not be part of the finished product, the printer and other labeling equipment are not exempt and replacement parts acquired for those items are not exempt.

FINDING

Taxpayer's protest is respectfully denied.

III. Duplicate Entries.

DISCUSSION

Taxpayer states that the audit review "included a detailed review of all [accounts payable] transactions [which] contained all purchases from vendors including those purchases that were recorded to Capital Assets." In addition, Taxpayer indicates that "[i]n addition to reviewing those detailed... files, the auditor reviewed a fixed asset listing and assessed tax on the total cost of various assets acquired during the audit period." Taxpayer objects on the ground that the audit's review resulted in the assessment of sales/use tax on duplicate items. Taxpayer states that a number of taxable items were included in the accounts payable records and in the fixed assets listing.

Under IC § 6-8.1-5-1(c), it is the Taxpayer's responsibility to establish that the assessment was "wrong." Based on the information provided, the Department is not prepared to sustain Taxpayer's objection but notes that the Department is prepared to agree that the information should be reviewed in a supplemental audit. The Audit Division is requested to review the information and to make whatever adjustment the Audit Division finds appropriate.

FINDING

Taxpayer's protest is sustained subject to a supplemental audit.

IV. Research and Development – Gross Retail Tax.

DISCUSSION

Taxpayer maintains that the Department's audit erred in determining that it should have been self-assessing use tax on the purchase of certain prototypes.

The audit report explains as follows. "During the audit period, records were reviewed that showed the [T]axpayer had been purchasing a large number of prototypes from various vendors that produce such items." The audit report further explained that, "The prototypes were used as a means to develop requirements that the [T]axpayer's customer had." In addition, "the prototypes were used as a means to gather data about how to make the proper tooling for the machinery but was in no way used in actual production."

The issue addressed in the audit report was whether or not the prototypes were resold. However, Taxpayer's representative argues that the prototypes are exempt because they fall within the research and development exemption found at IC § 6-2.5-5-40(b)(1)(A).

Taxpayer purchased computer prototypes which it claims is used in its "research and development" of new products. According to Taxpayer, it is entitled to a refund of sales tax paid on the prototypes. As support for its claim, Taxpayer cites to legal authority found at IC § 6-2.5-6-16. The exemption provides a sales tax exemption for "research and development equipment purchased after June 30, 2007." Sales Tax Information Bulletin 75 (October 2008); (20081029 Ind. Reg. 045080815 NRA).

IC § 6-2.5-6-16 reads as follows:

(a) As used in this section, "research and development equipment" has the meaning set forth in IC 6-2.5-5-40.

(b) A person is entitled to a refund equal to fifty percent (50[percent]) of the gross retail tax paid by the person under this article in a retail transaction occurring after June 30, 2005, and before July 1, 2007, to acquire research and development equipment.

(c) To receive the refund provided by this section, a person must claim the refund under IC 6-8.1-9 in the manner prescribed by the department. (Emphasis added).

IC § 6-2.5-5-40 provides follows:

(a) As used in this chapter, "research and development activities" does not include any of the following:
- (1) Efficiency surveys.
- (2) Management studies.
- (3) Consumer surveys.
- (4) Economic surveys.
- (5) Advertising or promotions.
- (6) Research in connection with literary, historical, or similar projects.
- (7) Testing for purposes of quality control.

(b) As used in this section, "research and development equipment" means tangible personal property that:
- (1) consists of or is a combination of:
  - (A) laboratory equipment;
  - (B) computers;
  - (C) computer software;
  - (D) telecommunications equipment; or
  - (E) testing equipment;
- (2) has not previously been used in Indiana for any purpose; and
- (3) is acquired by the purchaser for the purpose of research and development activities devoted directly to experimental or laboratory research and development for:
  - (A) new products;
  - (B) new uses of existing products; or

(C) improving or testing existing products.

(c) A retail transaction:

(1) involving research and development equipment; and

(2) occurring after June 30, 2007;

is exempt from the state gross retail tax.

Taxpayer describes the manner in which it acquires of these prototypes as follows: Although Taxpayer has its own design and engineering staff, on occasion it will engage an outside vendor to provide product development services. These services may include the design of a prototype. When the vendor completes the design phase of the project, Taxpayer purchases the prototypes along with the drawing and specifications for that prototype.

The prototype is then used to create sample packaging such as blisterpacks. Once the sample has been produced, it is forwarded to the blisterpack customer. Once the customer has approved the sample blisterpack, the previously provided drawings and specification are used to produce a metal mold which will be used in full scale production.

As Taxpayer explains:

The intent of the [T]axpayer is to purchase the design services of the provider to acquire a product that will be used to manufacture equipment. The specifications for these products are provided by the [T]axpayer's customers and are specific to one product and cannot be used for any other products. The vendor provides these services and transfers to the [T]axpayer a small plastic model with the required specification that will be used directly in the manufacturing of production equipment.

Taxpayer's engineering Department described the manner in which the prototypes are used.

[Taxpayer] has an internal engineering staff that typically provides all design and R & D functions. [Occasionally] when a customer has an immediate need and the Company's internal resources are not available, [Taxpayer] engages the services of an outside firm to provide these design and R & D services. The services provided by the vendor include the design and manufacturing of a "prototype."

The specifications for these "prototypes" are provided by the taxpayer's customer and are specific to one product and cannot be used for any other customer or for any other products. When purchasing the prototypes, [Taxpayer] receives a final product that consists of: 1) a CAD/CAM drawing of an item, and 2) a plastic rendition know as the "prototype." This tangible personal property consisting of the plastic rendition and drawings is [minimal] in cost to the services provided, and is transferred as part of the service provided by the vendor.

This small plastic prototype and related drawings are used in the R & D and sample part approval process and directly in the manufacturing of production tooling. The prototype itself is machined on a CNC milling center and then placed in a small manually operated thermoformer that produces a plastic sample product. These samples are provided to the customer for approval of the new product. Once the customer has approved the samples, the CAD/CAM machining program is used in a separate process as a model for the CNC machine to create an aluminum mold that is eventually used in the thermoforming process to mass produce the end thermoformed packages.

Taxpayer concludes that because "the "prototype" is used to create samples and test a new product, it qualifies for exemption as new equipment in Indiana used for testing and producing new products for R & D purposes. Additionally, the drawings received from the vendor are used directly in the production of the production tooling or manufacturing equipment used to create the [Taxpayer's] products.

Taxpayer further notes that, "Design services are not subject to gross retail tax." However it should be noted that the Department has no quarrel with its assertion that the price a consumer pays for services is not subject to sales/use tax. However, in reviewing the original audit report, there is no indication that the Department concluded that design services were subject to sales/use tax. Instead, the issue is described in the audit report as follows:

During the audit period, records were reviewed that showed the [T]axpayer had been purchasing a large number for prototypes from various vendors that produce such items. None of the items had Indiana sales tax paid upon them. Additionally, the [T]axpayer did not self-assess and remit sales and use tax to the Department upon such purchases.

Taxpayer has not met its burden under IC § 6-8.1-5-1(c) of establishing that the Department incorrectly assessed tax on the purchase of services.

The issue is whether or not the "large number of prototypes" are exempt pursuant to the Research and Development provision set out at IC § 6-2.5-5-40(b)(3)(A). As noted above, that provision states:

(b) As used in this section, "research and development equipment" means tangible personal property that:

(1) consists of or is a combination of:

(A) laboratory equipment;

The Department's Sales Tax Information Bulletin 75 (October 2008) is instructive explaining the definition of "equipment" as follows:

Research and development equipment means tangible personal property that consists of laboratory equipment, computers, computer software, telecommunications equipment, or testing equipment that has not previously been used in Indiana for any purpose and is acquired by the purchaser and devoted directly to

experimental or laboratory research and development for new products, new uses of existing products, or improving or testing existing products. Research and development equipment does not include hand powered tools or property with a useful life of less than one year.

In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." Indiana Dept. of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988).

IC § 6-2.5-6-16 like all tax exemption provisions, is strictly construed against exemption from the tax. Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282, 283 (Ind. Tax Ct. 1999); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629, 636 (Ind. Tax Ct. 1999).

Bearing in mind that the exemption Taxpayer seeks is "strictly construed in favor of taxation and against the exemption" – there is insufficient information to determine with any degree of certainty the purchases of the prototypes are exempt or that the prototypes have a "useful life" for more than one year.

FINDING

Taxpayer's protest is respectfully denied.

V. Electrical Conduit – Gross Retail Tax.

DISCUSSION

Taxpayer argues that it purchased electrical conduit in one of its buildings and that because the conduit houses wiring used to power its manufacturing equipment, the conduit is exempt from sales/use tax.

Taxpayer presumably relies on the language set out in 45 IAC 2.2-5-8(c)(2)(B) which exempts

An electrical distribution system, including generators, transformers, electrical switchgear, cables inside or outside the plant, and related equipment used to produce and/or supply electricity to exempt manufacturing equipment used in direct production.

Apparently, Taxpayer argues the conduit comes within the definition of "related equipment used to produce and/or supply electricity...." However, based on Taxpayer's description, there is insufficient information to establish that the conduit is used to supply electricity to Taxpayer's "manufacturing equipment used in direct production." Based upon the scanty information available on this particular issue, Taxpayer's protest cannot be sustained.

FINDING

Taxpayer's protest is respectfully denied.

VI. Conveyor Replacement Parts – Gross Retail Tax.

DISCUSSION

Taxpayer purchased conveyor systems which – according to Taxpayer – are used to transport work-in-process. During the audit, Taxpayer claimed that the conveyors "were not used in any way to move raw materials before [the raw materials] were introduced into the manufacturing process, or finished goods, or scrap." However, the audit concluded that some of Taxpayer's conveyors "were clearly used to move raw materials before they were introduced into the manufacturing process." The audit noted that "no documentation was provided... that specifically documents where each of the conveyors assessed in the audit was used and what the role of these conveyors was."

In its protest, Taxpayer seeks a partial exemption for replacement parts purchased for use in Taxpayer's conveyor systems. As explained by Taxpayer, "As replacement parts may not always be traceable to the exact location on the conveyor or the exact production line, the [T]axpayer proposes that a reasonable portion of all conveyor replacement parts be treated in a like manner to the forklifts that also move both raw materials and finished goods and work in process." Taxpayer proposes that the conveyor system parts be granted a 70 percent exemption.

The audit report did indeed grant a 50 percent exemption for forklifts as result of a "discussion and plant tour with the [T]axpayer...." Both Taxpayer and the Department's representative agreed on the partial exemption after a review of Taxpayer's manufacturing process, reviewing diagram of that process, conducting a plant tour.

Taxpayer cites to IC § 6-2.5-5-3(b) as follows:

Except as provided in subsection (c), transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

More specifically, the Department's regulation addresses the issue raised by Taxpayer. 45 IAC 2.2-5-8(f)(3) states:

Transportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process.

As explained by Taxpayer, it is not the conveyor systems which are at issue but the replacement parts which are incorporated into those systems. Taxpayer therefore necessarily relies on 45 IAC 2.2-5-10(i)(2) which states in its entirety:

Replacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, however, are exempt from tax.

The audit determined that certain of the conveyors were used to transport "a large amount of raw materials that are transported via conveyors" and that conveyors are also used to transport items which "are produced by an outside company and shipped to [Taxpayer] for processing...." The audit was unable to determine to what extent the conveyors were used in an exempt manner and to what extent the conveyors are used in a taxable manner because "no documentation was provided by the [T]axpayer that specifically documents where each of the conveyors assessed in the audit was used and what the role of these conveyors was." Taxpayer asks that the Department grant a 70 percent exemption, however there is nothing substantive which would allow such a conclusion. Taxpayer may well be correct in arguing that some of its conveyors are used in an exempt manner but whether 10, 20, or 90 percent of the conveyors are exempt is an issue which cannot be resolved here based on the available information.

FINDING

Taxpayer's protest is respectfully denied.

VII. Ten-Percent Negligence Penalty.

DISCUSSION

Taxpayer asks that the Department abate the ten-percent negligence penalty. The audit indicated that the penalty was assessed because, "The [T]axpayer appears to have had major oversights on remitting use tax on additional purchases that were used in a taxable manner but did not pay or remit any tax upon those items" and because "[T]axpayer failed to self-assess and remit use tax on a very large portion of its purchases during the audit period...."

IC § 6-8.1-10-2.1(a)(3) requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. IC § 6-8.1-10-2.1(a)(2) requires a ten-percent penalty if the taxpayer "fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment."

IC § 6-8.1-10-2.1(d) states that, "If a person subject to the penalty imposed under this section can show that the failure to... pay the full amount of tax shown on the person's return... or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall wave the penalty."

Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC § 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed...."

Under IC § 6-8.1-5-1(c), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." An assessment – including the negligence penalty – is presumptively valid.

Taxpayer failed to self-assess use tax on a large number of items, and the fact that the Taxpayer had not established a reliable internal procedure by which to self-assess use tax, the Department is unable to agree that the Taxpayer exercised ordinary business care in determining its use tax liabilities.

FINDING

Taxpayer's protest is respectfully denied.

SUMMARY

The Audit Division is asked to review the documentation provided by Taxpayer, eliminate any duplicate entries, and make whatever adjustments to the assessment as are warranted.

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